SUPREME COURT, U. S.
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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1967

No. 159

B & L FARMS CO., ET AL.,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY TO MEMORANDUM FOR THE UNITED STATES IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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Under the provisions of Rule 23, and in order to point out what we think are erroneous or incorrect statements in the Government's memorandum in opposition, we feel that some reply would be helpful to the Court.

In the first place, we wish to point out that the opinion of the United States Court of Appeals for the Fifth Circuit is now reported in 368 F. 2d 571, and is styled "Memorandum Decision". The Court will note that insofar as the majority opinion was concerned, two of the three Judges on the panel simply had a per curiam affirmance without opinion of the decision of the United States District Court, Southern District of Florida, 238 F. Supp. 407. Circuit Judge John R. Brown wrote a dissenting opinion in which he recommended and found that the lower Court's order was erroneous and should be reversed. On the petition for rehearing the Court mentioned the case of *Nicholas, Trustee,* v. *United States,* 384 U, S. 678, 86 S. Ct. 1674, 16 L. Ed. 2d 853. The same two Judges denied the petition for rehearing and Circuit Judge John R. Brown again dissented.

In the memorandum of the United States in opposition, beginning on page 1, the memorandum says that the first question raised was whether the arrangement proceeding in Chapter XI, filed on August 1, 1958, required the corporation, which was operating on a cash basis of accounting, to change by operation of law to an accrual basis. The Solicitor General's brief in opposition, on page 4, makes this statement:

> "But even if a change in bookkeeping methods resulted for bankruptcy purposes, a change in tax accounting methods did not automatically follow."

We do not agree with this statement and believe we have demonstrated in the original petition that this is brought about by operation of law. On page 4 of the petition for writ of certiorari the petitioners discussed this proposition and pointed out that the book accounting and auditing arrangements as of August 1, 1958, the date the Chapter XI proceeding was filed, were transferred by op-

eration of law to the accrual basis, and upon passing of the title to all of the assets, first to the Receiver in the Chapter XI proceedings and subsequently to the Trustees in Bankruptcy, in the same fiscal year by operation of law accrued all of those trade accounts. In support of that position we cited the case of *U. S.* v. *Bradley*, C.C.A. 5, 321 F. 2d 224, which in substance held that the provisions of the Internal Revenue Code or the regulations as to technical accounting would be superseded by operation of law under the Bankruptcy Act. We also pointed out on page 5 of the petition that after August 1, 1958, under the receivership in the Chapter XI proceeding additional purchases were made from these trade creditors and that these accounts incurred by virtue of the continued operation had to be classified on the accrual basis. These were debts for value received in and from the various trade creditors, and the accounts were of equal parity to all other accounts and were treated as a lump sum for the creditors.

We pointed out that an arrangement was made in which all of these trade creditors were accrued on the books of the Receiver and that the plan encompassed pro rata payments to all of these creditors. This was in the late fall of 1958, but the operation by the Receiver in Chapter XI proceedings was unsuccessful and bankruptcy resulted on June 26, 1959, within the same fiscal year of August 1, 1958 to July 31, 1959.

The memorandum brief in opposition filed by the Government does not take into account or does not attempt to reply to the authority cited for this statement and position taken by the petitioners. This whole argument of the petitioners is met by the Government, as shown on page 5 of the memorandum, by this statement: "Nothing in the Bankruptcy Act determines the question of the bankrupt's

tax accounting method." The Government does not submit any authority other than that assumed statement.

In the footnote beginning on page 4 of the memorandum the Government claims as follows:

> "It is doubtful in any event that bankruptcy proceedings caused petitioner to use the 'accrual method' that Section 446(c)(2) of the 1954 Code allows for tax accounting purposes. The most that can be said is that a trustee in bankruptcy must schedule accounts receivable and payable for all interested parties and the bankruptcy court to see and act upon. But, the amounts that will in fact be paid out depend on the filing and proof of claims, and the ability of the trustees to reduce receivables to cash or the equivalent. Under the accrual method 'deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy.' Petitioner notably claims a deduction in the full amount of its trade indebtedness, even though by definition of bankruptcy the full amount was not likely to be paid, and petitioner has apparently made no effort to treat income items by accrual methods."

This statement, even though in a footnote, does not pretend to meet the real issue, because predicated upon that footnote and the argument on page 5 of the memorandum, the Government then makes this conclusive statement, beginning at the top of page 6:

> "If petitioner remained on a cash basis, the transfer of its assets to the trustees in bankruptcy in and of itself did not liquidate, and therefore did not constitute payment of the petitioner's indebtedness. A trustee in bankruptcy is not, as petitioner would have it, essentially a collection agent for the creditors."

That issue is one that was ignored by the lower Court and was ignored by the majority affirmance in the United States Court of Appeals for the Fifth Circuit.

The respondent, United States of America, concedes that the filing of the Chapter XI proceeding and the subsequent bankruptcy by operation of law matures these debts and requires all of these debts to be listed as accounts payable for equal distribution, or pro rata, according to the class. While making that concession the respondent continues to argue that bankruptcy or a Chapter XI proceeding has no effect upon any of the provisions of the Internal Revenue Code or Regulations.

We have previously pointed out the case of *U. S.* v. *Bradley,* C.C.A. 5, 321 F. 2d 224, but in view of the concessions made by the respondent as to the practical treatment of the creditors at the inception of the Chapter XI proceedings, we think there are several other cases which we have not previously cited that have a direct bearing.

In a recent decision of March 7, 1967, *In re Green, etc., United States of America, Petitioner on Review* v. *John J. Gaudio, Trustee in Bankruptcy,* U. S. District Court, D. Colorado, 264 F. Supp. 849, this same question of the priority or control of bankruptcy provisions over that of the Internal Revenue Code is further discussed, and we quote (see text, p. 851, second column):

> "The Government's contention that this rule should not apply because these taxes were incurred during the pendency of the Chapter 11 proceedings and the receivership, in our opinion, is without merit. It appears clear to us that the second sentence of § 7501(a) means that the trust fund mentioned in the first sentence is nevertheless subject to the provisions of § 64(a) of the Bankruptcy Act which establishes a priority for all expenses of administration including taxes. So

construed there is no conflict between § 7501(a) and § 64(a) of the Bankruptcy Act.

If, however, there is a conflict between § 7501(a) and § 64(a) of the Bankruptcy Act, we conclude that § 64(a) should prevail. In Guarantee Title & Trust Co. v. Title Guaranty & Surety Co., 224 U. S. 152, 32 S. Ct. 457, 56 L. Ed. 706 (1912) it was held that § 64 of the Bankruptcy Act prevailed over a general statute (Revised Statutes § 3466) which provided that in case of insolvency of one indebted to the United States, the debts due the United States shall be first satisfied and that this priority of the United States shall extend to cases in which an act of bankruptcy is committed.

In Davis v. Pringle, 268 U. S. 315, 45 S. Ct. 549, 69 L. Ed. 974 (1925) the Supreme Court approved Guarantee Title & Trust Co., supra, and again held that § 64 of the Bankruptcy Act prevailed over the priority of the United States provided in § 3466 of the Revised Statutes.

More recently, the Supreme Court has referred to the policy which led to the establishment by § 64(a)(1) of the Bankruptcy Act of priorities that place all expense of administration on a priority, including claims for taxes as a 'strong policy.' Nicholas v. United States, 384 U. S. 678 at 691, 86 S. Ct. 1674, 16 L. Ed. 2d 853(1966).

The Court in Guarantee T tle & Trust Co., supra, denominated the policy as 'beneficent.'

We can read into § 7501(a) no Congressional intent to repeal, revise or modify its 'strong' and 'beneficent' policy of subjecting the Government's tax claims to the priorities established by § 64(a) of the Bankruptcy Act."

This law has been completely ignored by the respondent. The bankruptcy law is supreme when it forces the debtor to file schedules and forces the trustee to recognize

all accounts, whether paid or not paid, on an accrual basis. The bankruptcy law, therefore, requires the change of the accounting method from a cash to an accrual basis, and if this should result in a conflict between the bankruptcy provisions and the Internal Revenue Code provisions, bankruptcy prevails. These accounts were accrued by operation of law from and after August 1, 1958, and when bankruptcy ensued on June 26, 1959 and all of the assets were transferred by operation of law to the trustee for the benefit of distribution to creditors, then payment had been made.

In the dissenting opinion of Circuit Judge Brown it was specifically pointed out that under Section 70(a) of the Bankruptcy Act, 11 U.S.C.A., § 110a, the trustee is vested by operation of law as of the date of bankruptcy with title to all of the non-exempt property of a bankrupt. Since the Bankruptcy Act of 1867 the Congress has recognized that insolvent estates are trusts of which the creditors are the beneficiaries, and Judge Brown points specifically to Section 44 of the Bankruptcy Act, 11 U.S.C.A., § 72, 2 Collier on Bankruptcy, ¶ 44.01. Judge Brown further pointed out that as of that date all of the assets of the bankrupt passed to the trustee and the costs of Court have to be borne by the trustee and the creditors rather than to be paid for out of general appropriations from tax funds. This opinion by Judge Brown was supported by his reference to the case of *Atkins* v. *Wilcox*, 5 Cir., 105 F. 595, 53 L. R. A. 118, 5 Am. B. R. 313. In that opinion of December 18, 1900, the Circuit Court of Appeals, Fifth Circuit, established this as the law even under the Bankruptcy Act of 1898:

> "Under Bankr. Act 1898, a trustee of a bankrupt is authorized, as representative of all the creditors, to contest the allowance of any claim filed against the estate."

It is from the language in this case, which so far as we know has never been changed in any reported decision, that Judge Brown concludes:

> "At the instant of bankruptcy the title to the assets vest in the Trustee, in trust for the creditors, pro rata according to the debts held by them as of that same instant. True, at that instant no creditor is entitled to receive, or to demand, from the Trustee any sum certain. The exact amount each creditor will receive must await the converting of the property to cash and the payment of the costs. But mere postponement of enjoyment has never been held to disqualify an interest as 'property.'
>
> As the District Court has observed, payment in cash or its equivalent has long been recognized. The transfer by operation of law of the assets of the bankrupt amounted to exactly that."

The fact that Judge Brown did not refer to these additional supporting decisions which were contained in the opinion in *In re Green, United States etc.* v. *John J. Gaudio,* 264 F. Supp. 849, does not weaken his opinion. We have submitted the above opinion to show that Judge Brown's conclusions were not only supported by this case and the case of *United States* v. *Bradley, supra,* but were amply supported by the other decisions above mentioned.

Counsel for the Government so answered to that position, as contained on page 7 of the memorandum, as follows:

> "The transfer of assets to a bankruptcy trustee is not a closed or completed transaction evidencing a loss. No loss can occur before the trustee applies the transferred assets in payment of the bankrupt's debts after proofs of claims have been filed and allowed."

This statement is contrary to the direct holding by this Court in the case of *Maynard* v. *Elliott,* 283 U. S. 273, 51 S.

Ct. 390. In speaking of the effect of bankruptcy in the construction of what was then Section 63 of the Bankruptcy Act, this Court said (see text, first column, p. 392, 51 S. Ct.):

> "Possible doubts as to the meaning of the section should be resolved in the light of the purpose of the Act 'to convert the assets of the bankrupt into cash for distribution among creditors, and then to relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.' Williams v. U. S. Fidelity Co., supra, page 554 of 236 U. S., 35 S. Ct. 289, 290; Central Trust Co. v. Chicago Auditorium, supra, page 591 of 240 U. S., 36 S. Ct. 412. If this purpose be given its appropriate weight, a meaning cannot be attributed to the plain words of subdivision (a) (4), which would so restrict them as to preclude proof of claim upon the liability of an indorser of commercial paper, and result in its survival of the bankrupt's discharge as an obligation enforceable against him.
>
> That some contingent claims are deemed not provable does not militate against this conclusion. The contingency of the bankrupt's obligation may be such as to render any claim upon it incapable of proof. It may be one beyond the control of the creditor, and dependent upon an event so fortuitous as to make it uncertain whether liability will ever attach."

Counsel for the Government has overlooked that as a part of the assets turned over on July 26, 1959 to the new trustees in bankruptcy there was a sum slightly in excess of $200,000.00 in cash. The pretrial statements and stipulations heretofore mentioned clearly showed the amount and value of the other property which, although not liquidated immediately upon the date of bankruptcy, had a fair market value in cash or its equivalent, as stipulated by the respondent. We respectfully say that the conclusion or assumption of the respondent as above set forth is entirely without foundation.

Counsel for the respondent admits that the case of *Stuart* v. *Commissioner*, 38 B.T.A. 1147, was based upon similar facts as the petitioners are now contending, and that the Board of Tax Appeals in that case held that when a petition in bankruptcy had been filed and an adjudication entered and the debtor had turned over all of his property to the trustee, there was a payment.

We will not further burden this Court with again answering the next contention of the Government when, as shown on page 7 of the memorandum, the Government says that the statement of the District Court was correct insofar as the District Judge stated that the Stuart case was directly contrary to the overwhelming weight of authority on this point. We have taken the direct position that there is no decision which could be construed as changing the doctrine of the Stuart case and that there is no overwhelming weight of authority on that point, and as a matter of fact there is no contrary authority. We have covered that point in the petition for certiorari on pages 7, 8 and 9.

We wish to point out again for emphasis that, as set forth on page 9 of the petition for certiorari, the passing of the title and possession to the trustee was not a contingent payment and it was not a substitute type of payment, but it was a direct payment, unconditional and subject only to the time which it took in the Bankruptcy Court to make ultimate distribution to the creditors. There is no opening for the Government to contend that it was uncertain as to what the loss was, because that was all covered in the pretrial stipulations, beginning at page 20 of the Record, and the supplemental pretrial stipulation, beginning at page 29 of the Record.

If there has ever been any doubt in the federal law on this subject—which we do not admit—certainly the

ruling of this Court in *Nicholas* v. *United States*, 384 U. S. 678, 86 S. Ct. 1674, decided June 13, 1966, cleared up any ambiguity. This case was not available at the time of the trial in the lower Court, nor was it available when the briefs were filed on the appeal to the United States Court of Appeals, Fifth Circuit. However, it was squarely raised in the petition for rehearing, which is shown as a part of the certified record sent from the United States Court of Appeals, Fifth Circuit, and is covered in the certificate of counsel for petitioners.

This Court, as shown by that part of the opinion in 86 S. Ct. 1674, second column, page 1679, said:

> "We believe that the decisions of this Court in *Sexton* and *Saper*, reflect the broad equitable principle that creditors should not be disadvantaged vis-a-vis one another by legal delays attributable solely to the time-consuming procedures inherent in the administration of the bankruptcy laws."

In footnote 11 reference is made to the Sexton case and the Court quoted the Sexton case with approval that on the filing and adjudication of bankruptcy that date fixes the moment when the affairs of the bankrupt are supposed to be wound up. Under this doctrine it is theoretically possible where there was a simple bankruptcy to liquidate and pay the creditors on the same day. As Judge Brown pointed out and as this Court has pointed out, the fact that that is not possible because of the procedure in the bankruptcy case, the creditors should not be put to a disadvantage. It is true that the creditors pay the costs of administration out of their portion and no further charge is made to the bankrupt, nor is any further charge supposed to be made from the public at large or from tax funds.

June 26, 1959, a period well within the current fiscal tax year, terminated the relationships directly between the debtor and its creditors. Everything that could be accomplished so far as the debtor was concerned was accomplished, when on that day all of its assets were turned over to the trustee by operation of law under Section 70. As of that time on it was a matter of simple detail in the amounts that were paid as of that moment, subject to determination. As we have above stated and we wish to reiterate, the amounts of the losses—the exact figures—are not here subject to review, because it was all stipulated to, as shown by the pretrial conferences and stipulations heretofore referred to.

We do not have any expression in the opinion or any logical reasoning or cases cited by the majority opinion of the United States Court of Appeals, Fifth Circuit. Thus we are not favored with any citation of authorities, with the exception that two of the three Judges on the panel by per curiam decision affirmed the judgment of the lower Court. We do not have any argument now in the memorandum in opposition to show whether or not Judge Brown in his dissenting opinion was wrong. We do not have anything in the memorandum in opposition from respondent's counsel wherein the Solicitor General of the United States makes the contention that the Stuart case is directly contrary to the overwhelming weight of authority on this point, with the bare exception that the Solicitor General contends that the District Judge was correct when he made that comment.

We have thoroughly discussed the questions involved in the *Parkford* v. *Commissioner* case, 133 F. 2d 249, 251, at pages 7, 8 and 25 of the petition for certiorari, and in particular, on page 8 of said petition, the petitioners elaborated that the facts in the Parkford case were not

in the least applicable to the same points involved in the Stuart case. Actually the opinion by the Ninth Circuit in that case did not depart from the rule of the Stuart case, and the United States District Judge, as well as the majority opinion of the United States Court of Appeals for the Fifth Circuit, erred in so construing that case. So far as we can tell the *Parkford* v. *Commissioner* case is the only basis for the holding by the lower Court that the doctrine of the Stuart case was contrary to the overwhelming weight of authority on this point. That case is not even authority on that point and certainly could not constitute the overwhelming weight of authority on the points raised and decided in the Stuart case.

SUMMARY AND CONCLUSION

The opposition of the respondent, United States of America, to the granting of certiorari is based on the contention:

> "The result below is in accord with the settled state of the law, and there is no occasion for further review." (Memo. p. 2).

The petition for certiorari makes out a case to the contrary and respondent's memorandum adds confirmation thereto.

The only bankruptcy case found to date involving deductible debts existing at the time of bankruptcy is *Stuart* v. *Commissioner*, 38 B.T.A. 1147. We have pointed out that *Parkford* v. *Commissioner*, 45 B.T.A. 461, relied on by respondent, did not involve deductible debts at the time of bankruptcy. These cases certainly did not settle the law favorable to respondent as to the effect of bankruptcy on the time a deduction may be taken by a cash basis taxpayer on account of previously incurred deductible debts.

The non-bankruptcy cases relied upon as weight of authority in opposition to the Stuart case are the commonly referred to "constructive payment" cases. Respondent contends (Memo. p. 6):

> "petitioner's transfer of assets placed him in no different position than a taxpayer who transfers assets to another party who assumes, but does not then pay, the taxpayer's business liabilities. Such a transferor cannot deduct the assumed but unpaid liabilities, and neither may petitioner." (Citing cases relied on).

The difference between a voluntary transfer of assets to a third party who assumes the indebtedness and a transfer of assets to a trustee in bankruptcy is clear. In the case of such voluntary transfer of assets the creditor is not a party bound by the transaction and may still enforce his claim against the debtor by Court action or otherwise; whereas, in the case of bankruptcy the creditor is a party bound by the transfer and proceedings and can no longer enforce his debt by Court action against the debtor, or even further negotiate with him for settlement of his claim.

Upon adjudication in bankruptcy the debtor is compelled to pay his money and assets over to the trustee in bankruptcy and he is finished. He no longer has any control over those assets and the distribution thereof to his creditors. Thereafter the trustee in bankruptcy becomes the representative of the creditors in the liquidation and distribution of such assets and they are bound by all lawful proceedings taken by their trustee in their behalf.

Payment may be made directly to a creditor or to a person authorized by law to receive payments. After bankruptcy the debtor is prohibited from making payment with any of his assets directly to a creditor; the trustee in bankruptcy is the only person authorized by law to receive payment of his assets.

Respondent's contention that the debtor should be barred from his deduction because the exact amount of payment later to be enjoyed by his trade creditors was not known at the time of adjudication in bankruptcy is not well founded. The amount of cash paid to the trustees was known; the value of other assets paid to the trustees could be determined by appraisal; the amount of trade creditors entitled to participate in the distribution of such assets was known, and stipulated to. The fact that the creditors must bear the burden of administrative costs out of the fund (which may also be deductible) should not lessen or postpone the deduction. For example, a creditor may be burdened with attorneys' fees in collecting a debt, but this does not lessen the debtor's deduction.

The fallacy of the Government's defense is well illustrated on page 8 of the memorandum in opposition:

> "As the Ninth Circuit stated in affirming *Parkford*, in reasoning equally applicable here, 'If (the bankrupt) had voluntarily compromised his (debts) with his creditors by an assignment of his assets he could hardly assert a deductible loss. We perceive no reason why he may do so in the present circumstances.' 133 F.2d at 251."

In our case respondent in all honesty must concede that if the debtor (bankrupt) had voluntarily compromised its debts with its trade creditors by assignment of its assets to them it could have taken the deduction in the year of the transaction. We perceive no reason why it may not do so where in bankruptcy it has been finally and irretrievably divested of its assets to pay its debts. (See statement to like effect in Stuart case, Pet. App. A-15)

At least one issue between petitioners and respondent as to the loss on account of the packing house seems clear. Respondent asserts:

> "Since the assets were depreciable, any deduction in excess of normal depreciation is governed by Section 167 of the 1954 Code and not by Section 165." (Memo. p. 8)

Petitioners claim the loss under Section 165. It is true that after the year in which petitioners' loss was claimed Regulation 1.167(a)(8) was adopted to replace Regulation 39.23(e) which was in effect for many years, but it will be noted that Regulation 1.165-2 effecting this change specifically makes Regulation 1.167(a)(8) applicable to losses allowed under Section 165 of the Code.

The restrictive interpretation of this Court in *Real Estate Title Co.* v. *United States*, 309 U. S. 13, limiting obsolescence losses claimed under the depreciation statute (now Section 167 of the 1954 Code) to functional causes has never been applied to sudden obsolescence losses allowed under the loss statute (now Section 165 of the 1954 Code) (see *S. S. White Dental Manufacturing Co.* v. *United States*, 55 F. Supp. 117). The cause of the loss was the forced discontinuance of its business. This point has been fully presented by petitioners in the lower Court by petition for rehearing, and in this Court by petition for writ of certiorari. While respondent has not replied to this argument, inferentially it does appear that respondent may contend that Regulation 1.167(a)(8) retroactively repealed the allowance of the deduction authorized under Section 165 upon discontinuance of business, but the respondent refuses to squarely meet the issue.

We believe that the petition for writ of certiorari and respondent's memorandum in opposition demonstrate the unsettled and confused status of the law as to when an

admitted loss on account of depreciable property is deductible, and the need of clarification by this Court.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a copy of the foregoing Reply to Memorandum for the United States in Opposition to Petition for Writ of Certiorari has been mailed this ..... day of September, 1967, to the Hon. William A. Meadows, Jr., United States Attorney, P. O. Box 1070, Post Office Building, Miami, Florida, and Hon. Thurgood Marshall, Solicitor General, Hon. Mitchell Rogovin, Assistant Attorney General, Hon. Crombie J. D. Garrett and Hon. Karl Schmeidler, Attorneys, Department of Justice, Washington, D. C. 20530.

WILLIAM GRESHAM WARD